

A decorative graphic at the top of the page consists of several parallel diagonal bars in black, orange, light blue, green, and cyan. A large, bold black number '8' is positioned on the orange bar.

8

Issues in informal finance

Small-scale producers and enterprises have long been known to account for a large share of economic activity in developing countries. Most of these enterprises are noncorporate: small farmers, producers, tradespeople, and independent traders. They do not maintain income statements and balance sheets, are not registered with any government office, and often are not licensed as businesses. Recent studies that have attempted to quantify their importance conclude that the noncorporate sector accounts for 30-70 percent of the labor force in some developing countries.

Noncorporate businesses differ greatly in their demand for financial services. Street vendors need short-term finance to buy stock, and they need a depository for temporary surpluses. Small-scale producers need somewhat larger and longer-term loans to buy equipment or to hire nonfamily labor. Small farmers need to cope with an uncertain and fluctuating income stream, which they do by accumulating liquid assets and sometimes rolling loans over to subsequent cropping seasons. As farming becomes more capital-intensive, farmers may also demand longer-term credit to buy equipment. This chapter examines the ability of informal and formal institutions to satisfy the financial needs of households, agriculture, and noncorporate enterprises.

Formal financial arrangements are often not well suited to the needs of the noncorporate sector. The sums involved can be too small for a formal institu-

tion because many of the costs of advancing a loan or accepting a deposit are independent of the size of the transaction. Often the cost to formal institutions of opening branches in villages and small towns is not justified by the business that can be generated. In one African country it was estimated that an institution serving a largely noncorporate clientele would require a minimum of 2,500 deposit accounts to cover the cost of a single employee for a year. Noncorporate borrowers rarely have collateral acceptable to banks. Their creditworthiness resides in their human capital, which is difficult for formal intermediaries to gauge. The interest rates that banks are allowed to pay for deposits or to charge on loans often fail to reflect these factors. All this makes supplying financial services to the informal sector unprofitable for formal institutions.

The popular view of informal finance is of powerful moneylenders who exploit the poor through usurious interest and unfair seizure of collateral. In fact, informal finance is both extensive and diverse. The informal sector accounts for most of the financial services provided to the noncorporate sector. In addition to family and friends, who provide a large percentage of the loans, informal finance consists of professional moneylenders, pawnbrokers, tradespeople, and associations of acquaintances. In separate studies of five Asian countries, professional moneylenders provided

less than 20 percent of informal rural credit; on average they accounted for only 6 percent.

Informal financial arrangements reduce transaction costs and risk in ways denied to formal institutions. Moneylenders, for example, can operate out of their own homes or on the street, maintain only the simplest accounts, and mix finance with other business. The services they provide are outside the review and control of the monetary authorities. The remaining costs can be fully reflected in implicit or explicit interest rates.

Freedom from regulation allows informal agents greater flexibility. But it also denies them many of the legal sanctions available to formal intermediaries. In place of formal legal mechanisms, informal agents rely on their knowledge of one another and on local sanction to reduce the risk of lending. Social standing and the ability to obtain future financial services are often at stake in the market for informal financial services. These sanctions are effective. That is why informal financial arrangements are so widespread (see Box 8.1).

Informal financial arrangements

Without trying to be exhaustive, this section offers examples of informal financial arrangements. The examples cover three main sorts of transactions: short-term finance for daily stocks or emergencies; finance to smooth a fluctuating income stream; and finance for larger, long-term investments. The limitations of informal arrangements are then examined.

Short-term credit

Noncorporate enterprises commonly require small amounts of short-term funds to cover immediate expenditures, such as a business opportunity, a social obligation, or an emergency. Such funding might come from moneylenders or pawnbrokers but is more likely to be borrowed from relatives or friends. The choice of arrangement will depend on cost and convenience.

But informal short-term credit may entail hidden costs. For instance, lending between friends and relatives often carries low interest or no explicit interest charge. In societies with strong traditions of mutual assistance and reciprocity, individuals who need funds can call on friends and relatives for help. Acceptance of such help obligates the borrower to reciprocate by providing nonfinancial services or by supplying funds in turn when the lender needs to borrow. These traditional obligations of mutual support can be a problem for those who wish to accumulate capital. The desire to protect personal savings from family and friends creates a strong demand for less accessible savings instruments when these become available.

Market vendors and other small businesses often turn to moneylenders for their short-term credit needs. The so-called five-six arrangement under which the borrower receives \$5 in the morning and repays \$6 to the lender in the evening is common. The interest rate of 20 percent a day seems extremely usurious. But the moneylender does not perform the transaction every day of the year, and

Box 8.1 Informal finance in Niger

A sample of 398 village households in rural Niger in 1986 indicated that informal credit accounted for 84 percent of total loans and was equal to 17 percent of agricultural income. Informal *tontines* (rotating savings and credit associations), money guards, and merchant finance predominate. The first two supply a variety of services in the local market, and merchant finance bridges formal and informal markets. Large wholesalers borrow from formal banks, purchase a range of consumer goods, and then consign these goods through a network of small village retailers. These retailers, in turn, may sell the items to villagers on credit.

Out of a sample of fifty-six tontines in twenty-two villages, some had only four members, others more than forty. The average member contribution ranged from 100 CFA francs (25 cents) to CF AF25,000 (\$70).

The total size of all fifty-six tontines, as measured by member contributions per meeting, was the equivalent of \$72,000. This suggests a promising base for deposit mobilization in rural Niger.

Many of the money guards are traders who have storage facilities, offer deposit and pawnbroking services, and market goods in other regions. Fifty-six money guards were surveyed in 1986 in the twenty-two villages in the tontine sample. Their deposit base ranged from several depositors to as many as 150, and (in the immediate postharvest season) from CF AF10,000 (\$30) to CF AF5 million (\$13,000). They neither paid interest on their deposits nor charged fees for safekeeping. Money guards also provided loans, the average size of which was CF AF55,000 (\$144).

Box 8.2 Rotating savings and credit associations

Rotating savings and credit associations (ROSCAs) are a popular form of informal finance. They have various aliases: *tanda* in Mexico, *pasanaku* in Bolivia, *san* in the Dominican Republic, *syndicate* in Belize, *gamaiyah* in Egypt, *isusu* in Nigeria, *susu* in Ghana, *tontine* in Niger (see Box 8.1), *hagbad* in Somalia, *xitique* in Mozambique, *arisan* in Indonesia, *paluwagan* in the Philippines, *chit fund* in India and Sri Lanka, *pia huey* in Thailand, *hui* in China, *kye* in Korea, and *ko* in Japan.

ROSCAs intermediate in the most basic way. A small number of individuals, typically six to forty, form a group and select a leader who periodically collects a given amount (a share) from each member. The money collected (the fund) is then given in rotation to each member of the group. In some countries, such as India and Cameroon, ROSCAs have evolved into formal banks.

Three types of ROSCAs are found in many countries. In common ROSCAs, the leader receives no special consideration (other than possibly getting the first fund). Commission ROSCAs pay their leaders, who in return may assume liability for defaults. Promotional ROSCAs are used by merchants to sell goods, especially consumer durables.

Loans are interest free in most common and promotional ROSCAs; the amount received is equal to the total paid in by the member. More sophisticated ROSCAs may allocate funds on the basis of discount

bids, a practice common in China, India, Thailand, and some parts of West Africa. The winner is the person willing to accept the largest reduction in share payment from other participants in return for receiving the next fund. All participants in a commission ROSCA, except the leader, pay for the right to participate and receive back less than they contribute.

Recent research in Bolivia showed that one-third to one-half of all adults living in urban areas often participated in ROSCAs and that their ROSCA payments amounted, on average, to about one-sixth of their salaries. These associations were even found among employees of formal financial intermediaries. Despite hyperinflation and poor loan recovery by formal lenders, Bolivians reported few problems in their ROSCAs. Studies show that a relatively high proportion of those with steady incomes in Cameroon, India, and Sri Lanka often participate in ROSCAs. These associations have also been reported among employees of the central banks of Belize, Bolivia, the Dominican Republic, and the Philippines.

The popularity of ROSCAs among low- and middle-income groups shows that people like to save, even under trying circumstances. The Bolivian research showed that more than 90 percent of the people interviewed joined ROSCAs primarily because they wanted to save more and felt that membership forced them to do so.

loan losses and transaction costs reduce the realized rate of return. To keep collection rates high and transaction costs low and to minimize the cost of idle funds, the moneylender maintains relations with the same borrowers. Conversely, borrowers are paying not only for that day's loan but also for continuing access to immediate credit.

Loans from moneylenders are typically short-term and are extended to clients of long standing; they are rarely tied to collateral. Most moneylenders use their own funds for lending. Interest rates are high. Where entry is restricted and alternative financial services are lacking, high interest rates may be partly a result of imbalances in economic and social power, but the cost and risk of small loans are also high. To meet the demand for timely and convenient loans, the moneylender must maintain adequate liquidity, some of which will be idle during slack periods. The opportunity cost of this reserve is part of the moneylender's costs. Many noncorporate agents with access to formal

credit may also borrow from moneylenders if formal lenders take too long to process an application. Two to three weeks is quick for many formal intermediaries, and two to three months is not uncommon. Often, loans from moneylenders are used to make a transaction at short notice, and funds from formal lenders are used to repay the moneylenders.

Borrowers who own marketable assets may turn to pawnbrokers for short-term credit. Pawnbrokers take possession of assets for a fixed term and lend against them at an agreed rate of interest. During the term of the loan the borrower is free to repay and thereby to redeem his asset. Once the term expires, the pawnbroker can sell the asset and keep the proceeds. Because the loan has collateral, the pawnbroker needs no further information about risk. But the pawnbroker must know the resale market well if he is to sell such assets profitably—especially since the borrower has the option of avoiding the pawnbroker altogether by

selling and then repurchasing the asset on his own.

Pawnbroking is an example of how collateral is used in some informal arrangements to reduce risk and fill the gaps in information that characterize the noncorporate sector. Other, slightly more sophisticated solutions include sale and repurchase arrangements (in which the borrower retains physical possession of the asset while the moneylender has legal title) and the use of overdraft checks for loan surety. In these cases commercial law makes repayment enforceable, and recourse to banking law continues to be avoided.

Seasonal credit and short-term savings

Another common need is to smooth fluctuations in income. This can be done with liquid savings or seasonal credit. In rural areas marketing intermediaries are often an important source of credit for farmers. In urban areas retailers may offer credit for the goods they sell. Marketing agents often provide lines of credit to farmers in return for a commitment to sell produce through the agents. The farmer may be charged explicit interest, or he may pay indirectly through the price received for his crop. The agent knows the farmer, and this reduces his risk and transaction costs.

It is sometimes difficult for analysts to determine the implicit interest charges when loans or repayments are made in kind. In the Sudan, for example, a merchant might provide a farmer with two sacks of millet in return for three sacks at harvest-time two months later. The apparent monthly interest rate is 25 percent. But the true rate is much lower because the price of millet is typically higher between harvests than at harvesttime.

Philippine corn traders provide credit to many farmers. Transaction costs are low for lender and borrower alike, and interest rates range from 2 to 3 percent a month. (Interest rates on bank loans to corn traders are 1.5–2.0 percent a month.) The terms of the loans are flexible—most range from four to five months—but because borrowers are vulnerable to the climate, it is common for traders to carry loans over to a second or even a third harvest. Although the interest costs of trader credit are higher than for loans from formal institutions, transaction costs are lower, and so the total cost of borrowing is roughly the same. The difference is that formal, targeted credit is simply not available to most corn producers when it is needed.

Noncorporate agents can smooth their consump-

tion by saving. Formal intermediaries have been slow to develop deposit services for this sector, but a variety of informal arrangements allow farmers, small businesses, and households to pool their savings. The simplest such arrangement is the use of money guards—local people who safeguard cash for those who have no secure means of doing so. Most such deposits earn no interest and are secured only by the word of the money guard. The guards maintain enough liquidity to return deposits at short notice. Some deposits may be used by the guards for business transactions or for lending, but if so the practice is seldom made public.

Informal deposit services are also provided by group savings associations. Deposits can be made at regular or irregular intervals. Funds are sometimes lent temporarily and then returned to the depositor at the end of an agreed period, or they can be applied to the cost of providing a public good. A popular arrangement is the rotating savings and credit association (ROSCA), which is described in detail in Box 8.2. Members pool money by making periodic payments into a fund, which then rotates among members as a lump-sum payout. This allows at least some members to finance large expenditures sooner than if they had relied on their own savings. Some ROSCAs even meet the demand for the larger and longer-term loans that are needed to finance the cost of housing.

The popularity of such arrangements shows the potential for pooling individual savings among small farmers or microentrepreneurs. In England and elsewhere building societies—which later became an important part of the formal financial system—often began as ROSCAs.

Long-term finance

Because informal lenders and their customers are small and isolated, the risks of long-term lending are greater. Not much term finance is provided by the informal sector, but some informal arrangements have developed, mainly for housing finance. One example is key money, as in Bolivia and Korea. A home buyer can lease his house in exchange for a large cash payment. After an agreed period the house and the money are reexchanged. The interest that could have been earned on the money is the rental value of the house. The recipient of key money may use it to finance a business venture or the purchase of the house, thus circumventing the lack of conventional mortgage finance. He must then save enough to return the

original amount to the renter by the end of the rental period.

Limitations of informal financial arrangements

Despite their success in providing financial services to small businesses that would otherwise lack them, informal financial arrangements do not meet all the needs of the sector. For example, such arrangements do not allow savings to be collected from more than a small group of individuals well known to one another, and they do not move funds over large distances. Especially in rural areas local markets may be segmented from national markets, which limits the supply of credit. Most loans are from family and friends or group associations and are at low interest rates. The higher rates that moneylenders and pawnbrokers charge are in large part due to the higher costs and risks associated with informal loans. But some loans from moneylenders are at very high interest rates because of the power imbalance that exists between borrower and lender. In fact, much of the traditional criticism of moneylenders has derived from the high interest charges and intimidating practices of loan sharks—lenders who often finance illegal activities. Except in housing finance, informal arrangements generally do not provide term finance. These shortcomings may inhibit the long-term planning and investment that are necessary if productivity is to rise.

The limitations of informal financial arrangements do not call for completely new institutions. Indeed, formal intermediaries have often failed where informal arrangements have prospered. Formal institutions, and the policymakers who set their rules, might learn much about these markets by studying informal arrangements more closely. Their essential features are these. Transactions are undertaken by mutual consent, so the arrangements must meet the needs of both the buyer and the seller of the service. Transaction costs are kept to a minimum. And lenders are able to reduce the risk of default by using knowledge that they have already gathered from other social or business dealings. Sometimes informal arrangements provide a basis for establishing links with formal institutions so as to provide a fuller range of services.

Semiformal finance

Several approaches have been tried to overcome the limitations of informal finance for the noncorporate sector. As discussed in Chapter 4, many

government programs of directed, low-cost lending have experienced serious difficulties. Two types of lending arrangements, which fall in the gray area between informal and formal finance, offer some promise. These are group lending schemes and cooperative financial institutions, which can be found the world over.

Group lending schemes

The funds for group lending schemes can come from a commercial bank, a government development bank, or private institutions. The role of the group varies. In some cases the funds are lent to the group as a whole, which then allocates them among members. Or loans may be made directly to individual members of the group. In either case the group provides a guarantee; it is answerable to the outside lender for the repayment of loans.

The idea is that by joining together, small borrowers can reduce the costs of borrowing and improve their access to credit. The outside lender's costs are reduced because lending to a group lowers the risk of dealing with small businesses and circumvents the problems involved in selecting borrowers. The groups themselves must be selective in accepting new members. In this way, groups act as a substitute for information about borrowers and thereby reduce the costs of processing loans. Group members encourage each other to repay on time so that the rest can qualify for loans in the future. This directly reduces the lender's commercial risks.

The two most common means of providing group accountability are (a) joint and several liability and (b) limited liability. Joint and several liability encourages extremely careful selection of members because any member can be held liable for the defaults of others. It may, however, deter the comparatively wealthy from joining the group, since they have more to lose. In rural Zimbabwe, schemes based on joint and several liability worked well in times of average production but fared worse than other schemes in the same area in times of drought and low production. The threat of default led farmers to withhold repayment and hope for a general amnesty, since they would be, in any event, accountable for other members' debts.

Group lending schemes based on limited liability are more common. In Malawi and Nepal borrowers are required to put part of their loans in a fund that would be forfeited if any member defaulted. If all members repay their loans, these deposits are

Box 8.3 The Grameen Bank: an alternative approach to noncorporate finance in Bangladesh

While the government struggled to create a viable rural banking system in Bangladesh, a small private initiative was started in 1976 to help the landless without normal bank collateral to obtain credit. This program has become the Grameen (Rural) Bank. The unique operating procedures of the Grameen Bank grew out of several earlier attempts to reach the rural poor and were a sharp departure from traditional banking. The bank's customers, who are restricted to the very poor, are organized into five-person groups, and each group member must establish a regular pattern of weekly saving before seeking a loan. The first two borrowers in a group must make several regular weekly payments on their loans before other group members can borrow. Most loans are to finance trading and the purchase of livestock.

By February 1987 the Grameen Bank was operating 300 branches covering 5,400 villages. Nearly 250,000 persons were participating, among them an increasing number of women, who accounted for about 75 percent of the total. The membership included about 13 percent of households with less than half an acre of land in the areas in which the bank was operating. Loans are small—on average, about 3,000 taka (\$100) in 1985. By the end of 1986 about Tk1.5 billion had been

disbursed, of which almost Tk1.2 billion had been recovered. Outstanding loans were thus about Tk300 million, with almost 70 percent held by women borrowers.

In sharp contrast to the Bangladesh commercial banking system, the Grameen Bank has experienced excellent loan recovery. As of February 1987 about 97 percent of loans had been recovered within one year after disbursement and almost 99 percent within two years. This good performance is reportedly attributable to a combination of factors; close supervision of field operations, dedicated service by bank staff, borrowing for purposes that generate regular income, solidarity within groups, and repayment in weekly installments. Another factor which encourages repayment is the borrower's knowledge that the availability of future loans depends on the repayment of borrowed funds.

Bank staff meet weekly with groups to disburse loans, collect savings deposits and loan payments, and provide training in financial responsibility. This means high operating costs. The ratio of expenses to loans rose from 9 percent in 1984 to 18 percent in 1986. These high costs have been partially offset by low-cost funds from international agencies.

returned. This practice has resulted in a good record of repayment. In Malawi, where 10 percent of loans was held as security, 97 percent of seasonal credit disbursed between 1969 and 1985 was recovered. In Nepal's Small Farmer Development Program, which required security deposits of 5 percent, the repayment rate in 1984 was 88 percent. These repayment rates compare favorably with other small-borrower credit programs. Another way of imposing limited liability is to link continued access to credit with prompt repayment of existing loans (as is done in Ghana, Malawi, and Zimbabwe).

Group lending schemes have improved access to credit in many countries, but they too have drawbacks. Groups have often been created at the initiative of governments or private development agencies. This top-down approach means that a scheme can be extended rapidly, but it may undercut the force of local sanction. In one Latin American scheme, bank employees formed groups from lines of borrowers at their windows. Such arbitrary selection is unlikely to achieve group accountability. A second shortcoming is that the schemes rely

on external funds. Few collect deposits, partly because the supply of cheap external funds reduces the intermediary's incentive to provide this service, but also because deposit taking is viewed as too complex a task for unpaid group leaders. Despite these drawbacks, some group lenders, such as the Grameen Bank of Bangladesh, have an impressive record (see Box 8.3).

Cooperative finance

In group lending, borrowers and intermediaries are separate entities. In a cooperative arrangement, borrowers and depositors own the intermediary. In some countries such cooperatives fall outside the regulations that govern banks and similar institutions. This can give financial cooperatives flexibility, but it can also cut them off from the rediscounting and other facilities that are generally available to other institutions.

In many developing countries cooperatives operate under a government department that supports them with funds, technical assistance, and policy guidance. Government support is attractive to the

cooperatives' managers because it allows lending to expand quickly, but it weakens the incentive of cooperative members to provide their own finance. When loans are made according to government directive, lenders may find it difficult to collect. Such loans are often seen as grants and hence as resources that can be spent on consumption. Often, cooperatives have been promoted as a counter to usurious moneylenders and marketing agents. This has sometimes led the advocates of cooperatives and credit unions to think that financial services can be supplied to small producers for less than the real cost.

Moreover, the goals of government and cooperatives can differ greatly: governments often view cooperatives as instruments for the conduct of broader policy. In Africa, for example, a ministry wished to use the cooperative credit system to channel low-interest funds from foreign donors to targeted programs. When the ministry's plan was presented to the cooperative, the director declined because he felt that the funds would never be recouped by his institution. The director was told to reconsider or resign. The plan went into effect, repayment rates were extremely low, and other cooperative lending programs were undermined. The cooperative managed to refuse liability for nonrepayment, but the defaults affected repayments of the institution's other loans.

Similarly, the support of foreign donors can be a mixed blessing. Cooperatives may seem a suitable channel for development funds, but they often end up with heavy liabilities and a bad collection record. This mirrors the experience of development banks discussed in Chapter 4. Cooperatives that lend internally generated funds with an eye on the rate of return do better than those that are told what to do by outsiders. Even those loans that involve no liability for the cooperative incur staff costs which may overburden a small institution.

Despite the difficulties, cooperatives are a good way of increasing access to financial services. Their costs are often low because they use volunteer labor and because they can reduce risk through group accountability and local sanction. Where governments have been more concerned with the viability of cooperatives than with social objectives—and where interest rate restrictions have been relatively modest—cooperatives have flourished and the supply of financial services has broadened. In Togo, for example, savings in the credit union system grew by 25 percent a year and loans by 33 percent a year during 1977–86. Members elect a board of directors, which decides on

interest rates, dividends on shares, and lending policies. The credit unions are federated, and they jointly manage a central fund, invest in low-risk financial instruments, and mediate transfers between member unions with surplus funds and those with deficits. Loans from the central fund to unions lacking liquidity amounted to only 13 percent of its assets; deposits with financial institutions accounted for 81 percent. Togo's credit unions, like informal suppliers of financial services, live or die in the marketplace. But unlike informal intermediaries, they have access to broader financial markets through their federated structure. As a result, they can intermediate between regions and diversify their assets.

Improving finance for the noncorporate sector

Although informal financial arrangements do serve the needs of the noncorporate sector, they cannot be regarded as adequate. Many of the attempts by governments and international donors to increase the supply of finance to the noncorporate sector have focused on providing access to affordable credit. They have foundered because they did not take into account the true costs and risks of lending to the sector. Lowering the costs and risks would help to put the sector within reach of formal institutions. Greater competition between formal and informal lenders would improve the allocation of resources.

Improving the legal environment

Legal reforms could make it easier for small enterprises with relatively large financial needs to use formal services. Such reforms include better definition and enforcement of property rights. Squatters and small farmers with clear land titles would then have an acceptable form of collateral. Property laws that limit inheritance by women or prohibit married women from holding property in their own names limit their access to credit. In many countries banking laws require women to obtain permission from their husbands or fathers to borrow. In much of Africa such laws reduce agricultural investment by placing an economically irrelevant barrier between the farmer and her source of finance.

Laws meant to protect borrowers have often made loan contracts harder to enforce and have thereby raised the risk of lending. Licensing and registration formalities and taxation of businesses need to be kept in check. Small businesses in Peru,

for example, are forced to operate clandestinely because legal status costs too much. So regulation fails even in its narrow objective. Meanwhile, the economic welfare of suppliers and customers is reduced because businesses would have better access to formal credit if they were properly registered and licensed.

Links between informal and formal finance

Improvements in the provision of financial services might be gained by upgrading informal arrangements and linking them to formal institutions. This implies building upon, not supplanting, the existing arrangements. The linking of informal arrangements with cooperatives is becoming increasingly common in Africa. In Kinkala, a small rural town in the People's Republic of the Congo, a savings and credit cooperative, *Coopérative d'Épargne et de Crédit (COOPEC)*, has 268 members. Informal arrangements operate in the local market. Among them is a ROSCA with twenty-four members. Each member contributes 2,000 CFA francs a month (about \$4.50 in 1985) and receives the total collection of CFAF48,000 every two years. This scheme has been linked with COOPEC so that ROSCA members (who are also enrolled in the cooperative) make their monthly contribution to the COOPEC manager, who deposits the total CFAF48,000 in a savings account. ROSCA members are considered a good risk; their loan applications are looked upon favorably by the COOPEC loan committee. In this way, COOPEC has mobilized funds from its members and has satisfied credit demand.

An example of an apparently successful conversion of borrowing groups into a cooperative bank is the Working Women's Forum of Madras. In 1978 thirty women engaged in petty trade organized as a group to borrow from a commercial bank. Despite the success of this and other affiliated groups of Indian women, dissatisfaction with delays and inflexible disbursement and repayment schedules led them to form and staff their own bank in 1981.

An example of upgrading that produced mixed results is the conversion of indigenous savings and credit associations (*isusu*) into cooperatives in eastern Nigeria. Cooperatives based on *isusu* performed better in most respects than the rest. Members of these cooperatives, however, not only remained members of indigenous savings and credit associations but also held most of their savings there. This was partly because the government gave the cooperatives easy access to funds,

which reduced their incentive to collect deposits and undercut their independence. Many cooperative members, seeing that this new source of finance was risky, continued to rely on the informal arrangements. If the advantages of formality are visible and worthwhile, clients will participate and the institution will prosper. If not, they will return to the informal arrangements.

Formal intermediation for the noncorporate sector

Governments in many developing countries have encouraged formal institutions to serve the noncorporate sector. The means have included low-cost rediscount facilities for targeted lending through commercial banks, mandatory lending targets, and state-supported lending institutions. As Chapter 4 pointed out, these policies have created weak institutions and have thereby retarded the development of an efficient financial sector. They have been particularly damaging to the farm sector. These failures have come to be widely recognized, and a search for better solutions is under way.

Government-supported credit programs for the noncorporate sector can work. This is shown by the Badan Kredit Kecamatan (BKK) program in Indonesia (see Box 8.4). The program provides loans to rural enterprises and other small borrowers. Its viability has been maintained through interest rates that reflect lending costs and through the use of local sanction to enforce repayment. Shared profits encourage careful lending by BKK staff. Funds for the program have come from a government-mandated rediscounting facility, but the scheme was designed to maintain its independence.

Most of the successful formal institutions that serve the noncorporate sector, however, take deposits. Some institutions have greatly improved their position by doing so. The Banco Agrícola in the Dominican Republic began to offer passbook savings services in 1984 because it was in serious financial difficulty and urgently needed funds. By 1987 deposits had increased more than twentyfold. Although 60 percent of the depositors were previous borrowers from the institution, the rest were a new clientele who demanded only a safe and convenient store for liquidity.

Mobilization of voluntary deposits is desirable for several reasons. First, resource allocation can be improved if noncorporate agents have good deposit opportunities with positive real rates of interest and low transaction costs. Second, the flow of

Box 8.4 The Badan Kredit Kecamatan: financial innovation for the noncorporate sector in Indonesia

A government project in central Java, the Badan Kredit Kecamatan (BKK), lends tiny sums without collateral, largely to middle-aged peasant women. The BKK takes no longer than a week to process the one-page loan application form and does not supervise the loans.

It sounds like a recipe for disaster, yet the BKK is one of the most successful banking operations of its kind in the world. More than 35 percent of central Java's 8,500 villages are serviced by almost 500 subdistrict BKK units and 3,000 village posts. As of December 31, 1987, the BKK had 516,000 outstanding loans, 90 percent of which were for less than \$60. The BKK earned \$1.4 million in profits in 1987—a 14 percent return on the consolidated average outstanding portfolio for that year. Although the delinquency rate appears to be high—about 20 percent of outstanding loans—a closer look reveals that about three-quarters of arrears are several years old and should be written off. If these loans were subtracted, the actual repayment rate would be around 95 percent. (The BKK resists writing off bad debts because it feels that this sends the wrong message to borrowers.)

Starting in 1970, at the initiative of the governor of central Java, a BKK unit was created in each of the subdistricts (*kecamatan*) with an initial loan of 1 million rupiah. The loan was provided by the provincial government through the regional development bank at 1 percent interest per month. Additional funds are borrowed from the regional development bank, also at 1 percent interest per month. To bypass restrictions and paperwork, these BKK units were classified as nonbanks. This enabled the BKK to charge interest rates high enough to cover its costs, to avoid credit allocation, and to ignore traditional collateral requirements.

BKK loans are relatively cheap. Daily credit from moneylenders costs 20 percent a day. Monthly loans

through the organization of retired military officers cost 47.5 percent a month. The BKK's effective monthly rate is about 7.5 percent. A maximum of one week elapses between loan application and disbursement or rejection. If the first loan is repaid on time, new loans may be disbursed on the same day as the application. To get a loan, borrowers must fill out a simple one-page form and receive the approval of their village leader. No collateral is required. The system relies upon character references from local officials and peer pressure to encourage repayment.

The BKK reduces risk by making initial, short-term loans of about \$5. The administrative costs would seem prohibitive. But these loans introduce villagers to the financial system and enable them to graduate to larger loans. Most clients agreed that the greatest incentive for repaying on time was the expectation of getting another loan.

Each local BKK is an independent unit, not a bank branch. The staff of the regional development bank supervises the local units carefully. Salaries of BKK staff are low, but motivation to expand the portfolio and maintain a good collection rate is high, since 10 percent of a BKK's profits are divided among its staff. If a BKK goes bankrupt, staff members are no longer paid.

The main source of BKK funds has been loans from the regional development bank. Each loan to borrowers, however, has a mandatory savings component that earns interest and can be withdrawn when the loan is fully repaid. Recently the BKK began a voluntary savings program in nine units. More than \$30,000 was raised within seven months, with an average savings account of only \$9. Most of these voluntary savers were not BKK borrowers. The program will be duplicated at 400 of the healthiest units in 1988-89.

resources is typically from small savers to high-yield activities in the corporate sector. Inadequate deposit facilities can block the most important channel for this flow. Third, financial institutions require the independence and discipline that only voluntary deposits can provide. Institutions gain from extra information on potential borrowers, from the relationships that bind intermediary and client, and from the borrowers' knowledge that loans come from neighbors and not distant government or international agencies.

A strengthening of formal financial institutions (as discussed in Chapter 7) will be needed if they

are to provide sustainable financial services to the noncorporate sector. This means better management and improved incentives for employees. Innovation will be needed to contain the added risks of providing finance to the noncorporate sector. Group lending is one example. Another is the ratcheting of loans—making small loans initially and bigger ones after the borrower has proved creditworthy. This has been the practice of many group schemes and of both the Grameen Bank and the BKK.

Formal institutions could extend more of their services to the noncorporate sector if it was profitable to do so. This means improving the ability of

banks to reduce loan losses and establishing clear property rights for borrowers. Above all, profitability requires reducing directed credit programs with interest rate restrictions, since these fail to reflect the costs and risks involved in lending to the noncorporate sector.

Most of the financial needs of the noncorporate sector are met quite well by a wide variety of informal arrangements. Providers of informal services rely on their knowledge of their customers and on local sanction to contain credit risk. But some informal financial arrangements are costly, and they offer limited alternatives in instruments and suppliers.

Governments, in their efforts to overcome these shortcomings, have underestimated the difficulties of supplying services to the sector. Government programs have benefited the few people fortunate enough to receive cheap credit, but in general they have failed to reduce costs or to facilitate the transfer of resources from those with surplus funds to those who can make use of them or to promote viable financial institutions. Financial services to rural areas and to the urban poor would benefit from better legal systems, more clearly defined property rights, and better links between informal and formal financial institutions.